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Chapter 6 - ADMINISTRATIVE EXPENSES

In addition to the management, operating and maintenance expenses described in the preceding chapter, there are significant costs allocated to the administration of an association that must be included in the annual budget and must, therefore, also be part of each owner's property assessment. Administrative expenses are generally categorized as taxes, insurance, legal services, and audit services, although individual associations may incur other types of administrative expenses. This chapter describes the administrative costs that are generally common to all community associations.

Taxes:

Federal Income Tax - Whether incorporated or not, property owners' and condominium unit owners' associations may be considered corporations for tax purposes by the Internal Revenue Service (IRS), and most associations are required to file a federal income tax return at the end of their fiscal year. Since the tax laws are subject to change each year, and because the consequences of improper or incomplete exemption filing can be costly and punitive, it is strongly recommended that associations check this information and confirm their exempt status with the IRS and/or a tax advisor or accountant. The following information is for awareness purposes only and should not be relied upon for tax filing. Associations must usually file under the most recent revision of one of the following sections of the Internal Revenue Code of 1986 (IRC), as amended:

- a tax-exempt organization under Section 528, which specifically applies to property owners' and condominium unit owners' associations; or,
- a tax-exempt civic league or social welfare organization (Section 501I(4)), or a social or recreation club, Section 501I(7); or,
- file as a taxable corporation.

Tax-Exempt Status Under IRC Section 528 - community associations generally apply for tax-exempt status under Section 528 of the Internal Revenue Code, which was enacted as part of the 1976 Tax Reform Act to clarify the tax status of property owners' and condominium unit owners' associations. It provides tax-exempt status for that portion of an association's income that relates directly to maintenance and operation of the common properties, called "exempt function income." Other income of the association is taxed. Regulations to implement this section of the tax code became effective on April 18, 1980, and are retroactive to tax years after 1973. Under the regulations, an association qualifies for tax-exempt status on its exempt function income if all of the following criteria are met:

- It is organized and operated to provide for the acquisition, construction, management, maintenance and care of association property; and,

- substantially all (85%) of the units or property (square footage) is used by individuals for residential and auxiliary residential purposes; and,
- 60% or more of its gross income is derived from the membership dues, fees or assessments of owners in the association; and,
- 90% or more of its expenditures for the tax year is used for the acquisition, construction, management, maintenance and care of association property; and,
- no part of its net earnings benefits any shareholder, owner or individual.

Associations may apply for tax-exempt status under Section 528 by annually filing IRS Form 1120-H, "U.S. Income Tax Return for Homeowners Associations" on or before the 15th day of the third month after the end of the association's tax year. Under Section 528, association income received for fiscal years beginning after December 31, 1980, which is not tax-exempt is taxed at a rate of 30%, and includes interest or other income earned on reserve funds, fees from non-members for use of association facilities, and special fees such as party room fees, etc. IRS regulations permit a separate fee for the use of a facility (such as a swimming pool) to be considered as tax-exempt income if it is assessed annually and entitles the member to use the facility for the entire year/season. (See sample form 1120-H at the end of this chapter).

Tax-Exempt Status under IRC Section 501I - The most advantageous status for a community association is that of a tax-exempt organization under Section 501I of the Internal Revenue Code. An association that wishes to apply for tax-exempt status under 501I should obtain IRS Publication 557, "Tax-Exempt Status for Your Organization", and IRS package 1024 "Application for Recognition of Exemption under Section 501I". Copies can be obtained by calling the IRS "Forms Only" at 1-800-829-1040 or online at http://www.irs.gov/forms_pubs/index.html. For a property owners' or condominium unit owners' association to qualify for an exemption as a civic league or social welfare organization under Section 501I(4), the association must meet each/all of these terms and conditions as a "community association":

- The association must be a membership organization formed to own and maintain common green areas, streets, sidewalks, etc., and to enforce covenants to preserve the appearance of the development; and,
- the association must show that it is operated for the benefit of all the residents in the community; and,
- show that use and enjoyment of the common areas such as roads and park land or facilities it owns and maintains is extended to the general public and is not restricted solely to its members; and,
- show that it does not engage in activities directed to exterior maintenance of private residences.

The term “community” refers to a geographical unit that is a governmental subdivision, unit or district. Although an area represented by an association may not be a community (within the meaning of that term), it can still qualify for the tax exemption if the association’s activities benefit a community. Some associations may qualify as a tax-exempt social or recreational club under Section 501I(7) if their responsibilities are limited solely to maintaining recreational facilities. A requirement for common areas to be open to the public precludes many (homeowner) community associations and all condominium associations (common elements are privately owned) from qualifying as tax-exempt organizations under Section 501I(4). It should also be noted that civic associations might qualify for tax-exempt status under Section 501I(4) under somewhat different criteria as a social welfare organization. Because of the complexity and legal terminology required to apply for a tax exemption, an association may wish to hire a tax attorney to assist in filing for tax-exempt status. Once tax-exempt status is obtained, the association must make sure its activities remain within those permitted under the exemption. Even those associations that are exempt from federal income tax under Section 501I must file an annual information return on IRS Form 990 (or 990EZ) if its annual gross receipts are \$25,000 or more. If the annual gross receipts are less than \$25,000, Form 990 is not required, however, the association may still wish to use it to satisfy state tax reporting requirements. Also, if the association receives a Form 990 package with a preaddressed label, it is being asked to file the return to update IRS records. By following this instruction, the association will not have to be contacted in future years (see General Instructions A and B for IRS Form 990 and 990EZ, online at <http://www.irs.gov/pub/irs-pdf/i990-ez.pdf>).

Taxable Corporations - If an association does not qualify for tax-exempt status under Section 501I or Section 528, it must file a corporation tax return on Form 1120-H and be taxed for income generated over and above its expenditures (see IRS Publication 542, “Tax Information on Corporations.”) An association’s taxable income is often the same under both Section 528 and corporate tax statutes. It may be advantageous to be taxed as a corporation and deduct net operating losses and other corporate deductions that are not available under Section 528. In 2001, corporate taxable income not over \$50,000 was taxed at the rate of 15% versus 30% under Section 528. However, if taxed as a corporation, an association must be careful that the method used to set up reserve funds and levy special assessments for capital improvements meets IRS requirements to shelter the funds from taxation. A tax attorney or CPA should be consulted.

State Income Tax - Although Virginia’s property owners’ and condominium unit owners’ associations are generally required to file state income tax return Form 500, provisions in the state tax code typically result in little or no tax liability for the association. A Virginia nonprofit corporation, exempt from federal income tax under Section 501I of the Internal Revenue Code, is taxed by the state only on its unrelated business taxable income; otherwise no tax return has been required. Virginia income tax forms and

schedules for corporations are available from the Department of Taxation, Forms Request Unit, by calling (804) 367-8055 or (804) 367-8205, or at <http://www.tax.state.va.us>.

Fairfax County Real Estate Tax - Section §58.1-3284.1 of the Code of Virginia Ann., provides that all real property used for open or common space and owned by an automatic membership corporation or association “shall be construed as having no value in itself” for (tax) assessment purposes. The real value of such open or common space is proportionately assessed to each residential (or commercial) lot or property that is part of a planned development which contains the open or common space and which includes the right of each property owner to use the common space(s). Every local government is required by this law to reassess the open or common space(s) and each individual property of the development as of the date the open or common space is transferred from the developer to the association. Thus, the individual property tax assessments reflect the value of the common area(s) and no tax on these areas of real property is due from the association. Contact the Fairfax County Department of Tax Administration at <http://www.fairfaxcounty.gov/dta/homepage.htm>, or call (703) 222-8234 if your association receives a tax bill for its common ground real property.

Fairfax County Personal Property Tax - An association is responsible for paying personal property tax on the same basis as a business or individual unless exempted from taxation by an act of the General Assembly. Each year associations must declare taxable personal property between January 1st and May 1st on forms from the Fairfax County Department of Tax Administration. Tax bills are mailed in the summer to be paid by October 5th. For budget and assessment purposes, automobiles and trucks belonging to an association and weighing two tons or less are to be appraised at the average trade-in value listed in the January edition of the National Automobile Dealers Association (NADA) Official Used Car Guide. Fairfax County uses a computerized version of the NADA guide and does not adjust for vehicle options or mileage. Values for new vehicles not listed in the guide are assessed at a percentage of the Manufacturer’s Suggested Retail Price for the base model. Older vehicles not covered in the guide are assessed at a declining percentage of the last model year listed.

Other personal property of a condominium or homeowner association, (i.e., lawn and landscaping tractors and equipment, playground equipment, and business equipment/furniture such as desks, chairs and typewriters, file cabinets, etc.) are currently taxed at a rate of 1 cent per \$100 (of current value). Fairfax County adopted this lower tax rate “On the furniture, office, and maintenance equipment, (exclusive of Motor Vehicles), which are owned and used by an organization whose real property is assessed in accordance with §58.1-3284.1 and which is used by that organization for the purpose of maintaining or using the open or common space within a residential development as classified by the Code of Virginia Ann.”

In 2002, the General Assembly amended the Virginia Real Estate Cooperative Act (§ 55-428 of the Code of Virginia) to provide that residential cooperative associations shall not be deemed to be a business for certain state taxation purposes. It also classifies

tangible personal property of residential cooperative associations as household goods and personal effects making such property eligible for exemption from local personal property taxes. The amendment affects neither homeowner nor condominium associations that are still considered businesses for certain state and local taxation purposes. Legislation for similar tax exemption for condominium or property owners associations will likely follow, however, any tangible personal property remains taxable until the respective Acts are amended.

Business, Professional and Occupational License – (BPOL) Tax - Associations are generally exempt from the local BPOL gross receipts tax as long as the proceeds from any functions or events are used for the upkeep and beautification of association common grounds and facilities. However, in other jurisdictions where “local governments have become creative in searching for new revenue sources”,²⁷ some condominium unit owner associations have still been locally taxed on their assessment income. In response, the 2002 General Assembly amended (only) the Condominium Act to preempt such local taxation. Similar preemptive legislation for property owners associations may be introduced in the General Assembly in the near future. Information about the BPOL tax may be obtained from the Fairfax County Department of Tax Administration at (703) 222 8234) or online at <http://www.fairfaxcounty.gov/dta/homepage.htm>.

Fairfax County Public Utilities Tax - The County levies a tax on gas, electric and telephone service. The tax on residential gas service is based on consumption, and is \$0.05259 per CCF, with a maximum tax of \$4.00 per bill. The tax on commercial customers is \$0.04794 per CCF, with a maximum tax of \$300 per bill. For electric service, residential customers pay \$0.00605 per kWh or a maximum tax of \$4.00 per bill. The tax on commercial customers is \$0.00594 per kWh with a maximum tax of \$1,000 per bill. Telephone service is taxed at 22.2% of the local service only, and is limited to the first \$50 per month for residential use and the first \$1,600 per month for commercial use. These monthly phone taxes are billed and collected for the County by the various telephone companies.

In 1990, the County established guidelines that govern the utility tax treatment of common areas and improvements (facilities) in residential developments. For tax purposes only, these guidelines classify electric or gas service to common areas of residential developments (such as condominiums, townhouses or single-family detached homes) as residential use. Associations whose electric or gas service for common areas (a clubhouse or pool) is taxed at commercial rates may apply for a change in tax status. To qualify for residential tax status, at least 80% of the units in a building or development must be used for dwelling or recreational purposes. Contact the Tax Administration at (703) 324-INFO and access message #886, or online at <http://www.fairfaxcounty.gov/dta/homepage.htm> for a tax status change. This status is for utility tax (only) and has no bearing on a utility’s own classification for billing purposes.

²⁷ Lucia Anna Trigiani, “A Different Session,” Quorum Magazine, copyright by Washington Metropolitan Chapter Community Associations Institute, June 2002; page 22.

Federal and State Employment and Unemployment Taxes - An association that has employees may be responsible for federal and state income withholding taxes and social security taxes. Additionally, an association may be obligated to pay federal and state unemployment liability taxes. Information about the rules for paying and reporting federal income tax, social security taxes, and federal unemployment tax is contained in IRS Publication 15, Circular E, Employer's Tax Guide. The guide can be obtained by calling the IRS at (800) 829-1040 or at http://www.irs.gov/forms_pubs/index.html. Contact the following offices for information about:

Virginia Unemployment Taxes:	Virginia Employment Commission, Fairfax, VA. (703) 803-1100, or 1-800-828-1140 (Richmond, VA). http://www.vec.state.va.us/index.cfm?info=about_vec
Virginia employer income tax withholding:	Virginia Department of Taxation, Fairfax, VA. (703) 359-6715, or 1-888 268-2829 (toll free), or at http://www.tax.state.va.us

Common Interest Community Management Information Fund

A “common interest community” means developed real estate subject to a recorded declaration and containing some residential lots, common grounds, and/or facilities. The declaration and state law also require mandatory membership of all property owners and an obligation to pay assessments for maintenance and operation of the common grounds. In 1993, the Code of Virginia was amended to establish the Common Interest Community Management Information Fund, and assigns authority for management of the Fund to the Virginia Real Estate Board (VREB). In 2001, the Code of Virginia was further amended to establish a Community Association Liaison position to administer the Fund. This liaison is an information resource relating to the governance, administration and operation of common interest communities, and may provide non-binding interpretations of the laws or regulations that govern common interest communities. This liaison also provides information regarding public and private mediation centers that offer alternative dispute resolution services as a low-cost resolution of conflicts between associations and their members in lieu of legal proceedings. For more information, call the VREB Community Association Liaison at (804) 367-2941.

Under the laws, all condominium, cooperative, and property owners' associations are required to file an annual report and \$25 filing fee with the. The fee is to be used at the discretion of the VREB for research and education to promote the operation of common interest communities. The required annual report must be filed with the Virginia Real Estate Board, in the Department of Professional and Occupational Regulation. The following VREB forms and information are also available online at <http://www.state.va.us/dpor/indexie.html>:

TO ALL INTERESTED PARTIES:

Re: Common Interest Community Management Information Fund
Annual Report Requirements

Dear Sir/Madam:

The Common Interest Community Management Information Fund (Fund), managed by the Real Estate Board, was established by legislation to research and educate board members and those living in or considering living in common interest communities on improving the operation and management of associations through a Community Association Liaison. The Liaison also recommends expeditious and inexpensive ways (i.e. mediation) to resolve disputes in common interest communities.

Residential condominium, cooperative and property owner associations, as of July 1, 1993, are required to file an annual report and a fee with the Virginia Real Estate Board. The fee is deposited into the Fund.

It is recommended this memo, the "sample" annual report, and the revised annual report be printed and retained in your association's reference file. The revised annual report form requests the following:

- An existing association's certificate number.
- The association's name and address.
- When and in what city/county the association's declaration was filed.
- When the owners took over control from the declarant.
- The contact person for the association.
- The type of management (self or professional) for the association.
- The officers'/board members' names, addresses, and titles.
Associations may attach a list of officers/board members. Associations that are incorporated may send a copy of the annual report filed with the State Corporation Commission in lieu of listing names.
- **COMPLETE ALL QUESTIONS with available information.** (Whether the association is renewing or new.)

Effective June 2002, a certificate's expiration date will be the last day of the month the certificate is due to expire. The certificate's expiration date will not change if payment is received and posted after the certificate's expiration date. (ie. The certificate currently expires on August 8, 2002 and payment is received and posted September 20, 2002. The certificate will now expire on August 31, 2003.)

Mail the annual report, list of board members, and a \$25.00 a check payable to Treasurer of Virginia to:

Department of Professional & Occupational Regulation
P.O. Box 11066., Richmond, VA 23230-1066

Upon receipt, a renewed certificate will be sent to the contact's address.

If you have any questions or require further assistance, please do not hesitate to contact me at (804) 367-2941.

Sincerely,

Cynthia G. Schrier

Cynthia G. Schrier
COMMUNITY ASSOCIATION LIAISON

Commonwealth of Virginia
Department of Professional and Occupational Regulation
3600 West Broad Street
Post Office Box 11066
Richmond, Virginia 23230-1066
(804) 367-8510



**Real Estate Board
ASSOCIATION ANNUAL REPORT
Fee \$25.00**

A check or money order payable to the *TREASURER OF VIRGINIA* must be mailed with this form.

PLEASE TYPE OR PRINT.

1. Has this association previously filed with the Virginia Real Estate Board?
☐ No ☐ Yes If yes, please enter your certificate number. **0 2 5 0** _____
2. Full Name of Association _____
Mailing Address _____
City, State, Zip Code _____
- 3a. Type of Association
Property Owners ☐ Residential Condominium ☐ Cooperative ☐
- b. Date Owners Association Created MMM-YY _____
- c. Number of Units/Lots _____
4. Declaration Recorded MMM-YY _____ CITY/COUNTY _____
5. Name of Contact Person _____
Mailing Address _____
City, State, Zip Code _____
Telephone & Facsimile Numbers
Telephone () - - Facsimile () - -
6. Is the association self-managed? ☐ **OR** under contract with a company? ☐ If under contract, please answer 6a.
- 6a. Name of Management Company _____

MEMBERS OF CURRENT BOARD OF DIRECTORS/OFFICERS

- | | |
|---------------|---------------|
| 7. Name _____ | Name _____ |
| Title _____ | Title _____ |
| Address _____ | Address _____ |
| Name _____ | Name _____ |
| Title _____ | Title _____ |
| Address _____ | Address _____ |
| Name _____ | Name _____ |
| Title _____ | Title _____ |
| Address _____ | Address _____ |

(If more space is needed, attach additional sheets of paper.)

Effective June 2002, a certificate's expiration date will be the last day of the month the certificate is due to expire. The certificate's expiration date will not change if payment is received and posted after the certificate's expiration date.

8. _____
Signature Title Date

OFFICE USE ONLY	DATE	FEE	CLASS OF FEE	LICENSE NUMBER 0 2 5 0	ISSUE DATE
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ASSOCIATION DISCLOSURE PACKET NOTICE

Note to prospective purchasers: The lot you are considering purchasing is in a development which is subject to the provisions of the Virginia Property Owners' Association Act. Living in a community association carries with it certain rights, responsibilities and benefits.

Some of the benefits include the right to use common areas, which may include swimming pools, parks, playgrounds and other recreational facilities. In order to finance the operation of the community, each owner is responsible for and obligated to pay regular assessments, and if necessary, special assessments to ensure that the financial requirements are met. Failure to pay any of these assessments may result in a lien being placed on your property.

The use of common areas, financial obligations of lot owners' and other information concerning the rights, responsibilities and benefits resulting from the purchase of a lot in this common interest community are subject to the provisions of governing documents that typically include a declaration, bylaws, articles of incorporation and rules and regulations. These documents play an important role in association living and should be reviewed carefully prior to your purchase.

Some decisions of your association will be made by the board of directors, while others will be made by a vote of all association members, made up of the other lot owners in your development. You will be bound by all decisions of the association and the board of directors. The documents cited above contain information concerning the selection of members of the board of directors, meetings, voting requirements, and other important information you should become familiar with. **REMEMBER:** Failure to comply with the governing documents of your association can result in legal action being taken against you.

You may wish to become active in your association, either by running for the board of directors or by serving on a committee. Your involvement is important, as you will be bound by all decisions of the association and the board of directors.

The name of your association is:

Lot number and address:

Assessments and/or Mandatory Fees you are responsible for:

Assessments: _____ **per** _____

Special assessments: _____

Other entity or facility: _____

Other fees: _____

Failure to pay any of the above Assessments and/or mandatory Fees may result in nonjudicial foreclosure on your property or the following:

ALL DOCUMENTS AND INFORMATION CONTAINED IN THIS DISCLOSURE PACKET PLAY AN IMPORTANT ROLE IN LIVING WITHIN A COMMON INTEREST COMMUNITY AND SHOULD BE REVIEWED CAREFULLY PRIOR TO YOUR PURCHASE OF THE PROPERTY. A LIST OF THOSE DOCUMENTS YOU ARE ENTITLED TO RECEIVE IN ACCORDANCE WITH THE PROPERTY OWNERS' ASSOCIATION ACT IS PRINTED ON THE BACK OF THIS NOTICE.

Recipient Name (print): _____

Recipient signature: _____

Date: _____

The following is a list of documents you are entitled to receive in accordance with the Property Owners' Association Act.

- ♦ the name of your association, and if incorporated, the state of incorporation and the name and address of the registered agent;
- ♦ a statement of any approved expenditures that shall require an additional assessment during the current year or the immediately succeeding fiscal year;
- ♦ a statement of all assessments and other mandatory fees currently imposed by the association;
- ♦ a statement whether there is any other entity or facility to which the lot owner may be liable for fees or charges;
- ♦ the current reserve study report (or a summary thereof), a statement of the status and amount of any reserve or replacement fund and any portion of the fund allocated by the board for a specified project;
- ♦ a copy of the association's current budget (or a summary thereof) and a copy of its statement of income and expenses or financial condition for the last fiscal year available;
- ♦ a statement of the nature and status of any pending suit or unpaid judgment to which the association is a party which either could or would have a material impact on the association or which relates to the lot being purchased;
- ♦ a statement setting forth what insurance coverage is provided for all lot owners by the association, including any fidelity bond maintained by the association, and what additional insurance would normally be secured by each individual lot owner;
- ♦ a statement that any improvement or alteration made to the lot, or uses made of the lot or common area assigned thereto by the prior lot owner, are not in violation of any of the instruments referred to in this disclosure notice;
- ♦ a statement setting forth any restriction, limitation, or prohibition on the right of a lot owner to place a sign on the owner's lot advertising the lot for sale;
- ♦ a statement setting forth any restriction, limitation, or prohibition on the right of a lot owner to display any flag on the owner's lot, including, but not limited to reasonable restrictions as to the size, place and manner of placement or display of such flag and the installation of any flagpole or similar structure necessary to display such flag;
- ♦ a copy of the current declaration, the association's articles of incorporation and bylaws, and any rules and regulations or architectural guidelines adopted by the association;
- ♦ a copy of notice given to the lot owner by the association of any current or pending rule or architectural violation;
- ♦ a copy of the fully completed one-page cover sheet developed by the Real Estate Board pursuant to § 54.1-2105.1; and
- ♦ certification; if applicable, that the association has filed with the Real Estate Board the annual report required by §55-516.1 of the Code of Virginia; which certification shall indicate the filing number assigned by the Real Estate Board and the expiration date of such filing.

Insurance

Most condominium and homeowners associations are required to purchase property and liability insurance to protect the association from financial loss caused by destruction or damage to common areas and facilities, and from claims resulting from injuries to persons or damage to their belongings while on association property. Even if not required by the documents, an association should have insurance coverage to protect the association and the interests of the individual owners in the community. Meeting an association's insurance needs requires an understanding of the types of insurance needed and available. Associations should consult several insurance companies with experienced specialists in owners' association affairs and issues, not only for competitive rates, but also for comparable and differing opinions and recommendations.

Insurance varies greatly in coverage and cost. Given the specialized needs of associations, it is advisable to use knowledgeable agents to obtain appropriate coverage. Associations should request detailed proposals, outlining the coverage required, from several insurance companies. The resulting quotations should be comparable in coverage, although recommended alternatives with lower coverage (and cost), different exclusions, and suggested risk reduction strategies should be expected. A review by the association's attorney for need, sufficiency and cost of proposed insurance coverage should be considered by the board of directors prior to committing the association to a particular policy package.

Property Damage Insurance - Property damage insurance covers the costs to repair or reconstruct buildings and improvements if they are damaged or destroyed. Property damage insurance policies are generally of two types: "Basic" or "Named Peril" policies, and "All-risk" policies. Basic or Named Peril policies specify the types of damage included in the coverage – fire, wind, flood, hail, explosion, riot, etc. and would address a particular peril brought about by an association's design, location, type of facility, or other extenuating factor identified by the board of directors. If damage is caused by a peril that is not named, the loss is not covered. Endorsements commonly available to cover property damage perils excluded from "named-peril" policies include:

- Water damage – Most policies will not cover water damage unless it is caused by damage to the exterior of the building (such as a hole in the roof). A water damage endorsement will cover water damage to the interior of a building caused by water driven under doors by wind.
- Plate glass breakage – Typically insurance policies restrict payment for glass breakage to \$50 per pane and \$250 per claim. If an association is responsible for substantial amounts of glass, it may want to obtain an endorsement that will pay the full amount of any glass breakage.
- Sprinkler leakage – covers damage caused by a fire sprinkler system that activates or leaks unexpectedly. Such damage, however, may be covered under a water damage endorsement (see above).

- Vandalism – covers a loss caused by vandalism or malicious mischief, if the base policy does not cover such damage, or the base coverage is felt to be inadequate.
- Elevator insurance – covers accidents involving elevators, except those accidents caused by fire.
- Boiler and machinery insurance – provides protection against loss caused by or to boilers and mechanical or electrical machinery.
- Debris removal – covers the expense of cleaning up and removing debris after a loss. This coverage is particularly important for mid and high-rise buildings where debris removal can be very expensive.
- Conforming statute endorsements for older buildings – prevents the insurance from being invalidated if a damaged building does not conform to current local codes and provides additional coverage for costs incurred to bring the structure up to new building code requirements.
- Landscaping coverage – covers trees, plants and shrubs if they are damaged by fire, storms, vehicle accidents, exceeding the standard \$1,000 coverage in many all-risk policies. It also covers damage to landscaping from wind, hail, and vandalism, which are generally excluded under normal policies.
- Flood insurance – Generally, flood insurance is not sold by private insurance companies but the federal government sells insurance to cover direct flood and flood-related damage, including mudslide and erosion, under the National Flood Insurance Program. Flood insurance information can be obtained from the National Flood Insurance Program, P. O. Box 619, Lanham, MD. 20706, (tel. (800) 638-6620).

“All-risk” policies insure against loss from all perils except those specifically excluded. Individual insurance companies exclude different perils, but generally an all-risk policy excludes earthquake, flood, sewer back-up, boiler explosions, and nuclear contamination. The exclusions listed in an all-risk policy should be carefully reviewed and special endorsements or waivers obtained to provide coverage and protect the association from an excluded peril that may very well exist. In the insurance market, this may not be as easy as it once was, although the main problem area in insurance has been in liability coverage, not property damage or casualty insurance.

Property damage insurance should cover all common property including buildings, structures, and improvements such as swimming pools, tennis courts and fences, and should also cover an association’s personal property such as pool furniture, recreation and office equipment. Personal property should also be insured against burglary and theft and newly acquired property should be automatically covered under the association’s policy. Insured property should generally be covered for its full replacement value. Determination of the value of real and personal property for

insurance purposes is difficult due to inflation and increasing construction and material costs. The most accurate method is to obtain a figure from an independent professional appraiser, but this can be expensive. Most large insurance companies will provide estimates that are sufficiently accurate for insurance purposes. Some companies also offer “inflation guard” endorsements that automatically increase insurance coverage in an amount equal to inflation on a quarterly basis.

Most property insurance policies contain a co-insurance clause that reduces the insurance premium. A co-insurance clause requires that an association purchase insurance in an amount equal to at least 80% or 90% of the replacement of the property insured. If the insurance is not equal to the percent specified in the co-insurance clause, a partial loss will not be fully covered. The insurance company pays for damages in an amount equal to the percentage of the insurance coverage. For example, an association has a co-insurance clause requiring 90% coverage, and is insured for \$1,000,000. A \$30,000 loss is incurred, and an appraisal shows that the actual value of the property is \$1,200,000. Since the insurance was not equal to 90% of the value of the property, the company will pay \$27,780 for the damage, according to the formula:

$$\frac{\text{Insurance carried} \times \text{amount of loss}}{\% \text{ of co-insurance} \times \text{property value}} = \text{amount of insurance}$$

or

$$\frac{\$1,000,000 \times \$30,000}{90\% \times \$1,200,000} = \$27,778$$

To fully protect itself, an association can obtain a “stipulated amount clause” which states that the insurance company agrees that the amount of the insurance at the inception or on the anniversary date of the policy is adequate to provide full coverage for any partial loss.

Most policies contain deductibles which can reduce the premium and the need to process small claims. Deductibles are generally \$100, \$500, \$1,000, or more depending upon the degree of risk an association feels it can assume. An association should not assume risk that could pose a financial hardship on the association. The terms and application of the deductibles in the policy should be scrutinized to protect the association from incurring multiple deductibles which can be applied on either a per building or per occurrence basis. Some policies include a maximum deductible in multi-building losses. Property damage insurance policies should contain a “waiver of subrogation” clause to prevent the insurance company from suing association members to recover for any claims it has paid. The policy should also include a “no control” provision so that the association is protected against any increased hazard that is beyond the association’s control, such as that caused by an owner.

Liability Insurance - Liability insurance protects an association against claims resulting from injury to persons or damage to their property while on the common grounds. A

comprehensive general liability policy covers bodily injury, property damage and medical payments. Bodily injury coverage pays for assessed damages for accidental injury, illness or death, and includes payments for medical expenses, pain and suffering, and loss of income. Property damage insurance covers awards for damage to or destruction of a person's property. Medical payments coverage pays the medical costs of guests or the public who are injured on the common areas without regard to legal liability. Liability coverage is available to cover other specific situations that could increase an association's risk, including:

- garage keepers liability covers loss to owners' or guests' automobiles when parked in common area parking lots or garages;
- host liquor liability covers claims for accidents resulting from liquor served at association-sponsored functions or at private parties held on the common areas;
- hired and non-owned automobile liability covers an association in case of an accident involving a vehicle rented in the association's name or an accident involving an employee or board member who uses his/her own vehicle on association business. (The coverage is not generally primary coverage and is paid only if the employee or board member does not have sufficient personal insurance coverage);
- product liability insurance protects the association from claims resulting from defects or mislabeling of products sold at association sponsored bazaars, association operated snack bars, etc.; and
- personal injury insurance covers the association against claims for false arrest, libel, slander, invasion of privacy, etc. The insurance should cover personal injury suits brought against an association by employees or former employees.

A liability policy purchased by an association should cover the association and its members for acts, omissions or use of the common areas, and provide coverage for association activities off the common property (for example, an annual meeting held in a local church or school meeting room). The policy should contain:

- a "severability of interest clause" to protect the association when a claim is brought against a unit owner.
- a "care, custody and control" clause to cover any non-association property that is in the care, custody or control of the association;
- and a "cross liability" endorsement to cover an owner injured on the common areas.

Directors and Officers Liability Insurance - Although widely purchased as liability protection for individual representatives (directors, officers, etc.) and the association itself, this coverage is usually misunderstood and thus often ineffective.²⁸ Directors and Officers Liability Insurance, or “D and O”, (sometimes called “errors and omissions insurance”) pays for the financial consequences of certain wrongful acts and behavior or negligence on the part of board members (or the association) that are not covered by a Comprehensive General Liability policy. Such wrongful acts/behavior could include:

- bad faith actions, breach of loyalty, and/or conflict of interest;
- failure to maintain the books and records, to collect assessments, or to maintain correct insurance;
- failure to enforce covenants, bylaws, rules and regulations;
- discrimination and/or wrongful hiring and termination practices, security and/or other personnel issues;
- mismanagement of the budget, association affairs, and/or failure to maintain adequate reserves; and
- failure to fully disclose required association information in a resale package.

Potential claimants include individual property owners (or their tenants), other board members, employees, contractors, a management company or its personnel; - virtually anyone connected to or conducting business with the association. Such claims and suits may involve monetary and non-monetary damages. Section 13.1-870 “General standards of conduct for directors” of Title 13.1 of the Virginia Code, provides that a director of a mandatory community association incorporated under Chapter 10 “Virginia Nonstock Corporation Act,” shall discharge his/her duties as a director in accordance with his/her good faith judgment of the best interests of the corporation. Provisions enacted in 1987 and later provide personal liability immunity for an uncompensated officer or director (and limit the liability exposure of a compensated officer or director) for damages unless the officer or director engaged in willful misconduct or a knowing violation of the criminal law. Subsequently, the same protections of immunity and limitation on liability were enacted for unincorporated associations.

However, officers and directors are not immune from being sued, or from the costly litigation to defend against such suits. The degree to which officers and directors (or other association representatives – elected, appointed, or volunteers) are protected from liability by these provisions has yet to be tested in the courts. And while these individuals may qualify for immunity from liability risk under these provisions, the association itself may not be immune. Furthermore, if an association’s bylaws contain a

²⁸ Community Association Insurance, CAI-GAP Report #4, pub. by Community Associations Institute, Alexandria, VA, 4th Ed., 1997, pg. 26.

mandate to protect its directors and officers (or others) from personal liability for their actions, the association must bear the expense of defending its officers and representative(s). The employees of a contracted property management company have, or can be required by the terms of a management services contract to have, their own professional liability policy separate from that of the association.

Many associations provide for the indemnification of board members and other representatives of the association by purchasing a D and O policy which can be written as part of an association's commercial package policy or on a stand alone basis. It is critical to recognize that there is no uniform contract of insurance for directors and officers liability coverage, as there is for other types of coverage. Although there are similarities among the many available policies, there are also significant differences, and no standard forms; all have varied limitations, exclusions, options and endorsements. The definition of who is insured is one of the most important differences between Directors policies. In addition to a standard deductible, some D and O policies include a percentage copay by the insured, which usually can be waived for a corresponding increase in the premium. Legal defense costs are normally within D and O policy limits and not a supplemental benefit as with Comprehensive General Liability policies. The insurer may or may not have a duty to defend (the insured association or officer), but, if so, it will usually also retain the right to select legal counsel and to settle claims (out of court) prior to trial. Some of the other more significant exclusions in most D and O policies include:²⁹

- insurance decisions
- contractual liability
- theft and dishonesty
- property damage
- libel and slander
- non-monetary damages
- insured vs. uninsured
- willful misconduct
- bodily injury
- discrimination and civil rights

Directors and Officers policies are often purchased in \$1 million increments. Premium rates are competitive and should be based, in part, on the size or number of members of the association. The limit of liability payable for all claims may not exceed the limit stated on the declaration page of the policy during any calendar year. D and O liability coverage can be chosen to meet an association's particular circumstances and risk exposure. The association's board of directors and counsel should carefully weigh its situation and examine the exclusions, limitations and other differences between D and O policies when deciding on a specific policy and the insurance company providing the coverage, or whether D and O liability coverage is necessary.

Umbrella Liability Insurance - Umbrella liability insurance provides supplementary insurance to cover awards above the amount of an association's regular insurance and is most often purchased in \$1 million increments. This may be difficult to obtain at a reasonable price, but it often covers exposures not contained in the association's regular policy, but with substantial deductibles. The amount of liability insurance needed by an

²⁹ Community Association Insurance, CAI-GAP Report #4, pub. by Community Associations Institute, Alexandria, VA, 1994, pg. 26.

association will depend upon its recreational facilities, the types of association-sanctioned activities and the extent of the common properties. Liability coverage assumed by other parties, such as pool contractors, may also vary the expense for association coverage. It is advisable for an association to attempt to reduce its risk exposure by working with its insurance company to eliminate any hazards present in the community. Many insurance companies are now refusing liability coverage for swimming pools with diving boards, amenities such as hot tubs or saunas, and other risks they view as likely to generate very large claims. Often, proper posting of signs, proper fencing, or the elimination of association sponsorship of an activity can reduce an insurance premium. For example, an association with a lake or pond may find that its insurance liability is reduced if it prohibits the more hazardous uses of the water, such as for swimming and skating, and limits sanctioned activities to boating and fishing. Similarly adoption and enforcement of sound rules or regulations with respect to use of any association facilities should be a plus in reducing risk and the expense of insurance.

Additional Insurance Considerations for Condominium Associations:

Insurance requirements are more complex for condominiums than for property owners' associations because of the joint ownership, the type of structure, and extent of the common area(s). Condominium documents are usually very explicit as to the amounts and types of insurance that must be maintained. These requirements should be very carefully reviewed to make certain that any insurance purchased is in compliance with them. A condominium association may also investigate insuring the appliances and kitchen and bathroom fixtures in the individual units, as this coverage will be cheaper under the condominium's basic policy coverage than if obtained by individual owners. In addition to the exclusions and endorsements noted in the previous discussion, a condominium association may include the following provisions in its insurance policies:

- an "include-exclude" provision which makes the association's policy the master policy in cases where the association and unit owner have duplicate coverage;
- a waiver of the right of the insurer to repair or rebuild after a loss if a decision is made by the association, pursuant to the Condominium Act and condominium bylaws, not to rebuild the condominium. (The waiver should also provide that the insurance company will pay the full amount of the insurance as if a total loss had occurred); and
- an endorsement that the insurance purchased conforms to the requirements of the documents regardless of the limitations in the policy.

Fidelity Bond - As association's documents may require the purchase of a fidelity bond to cover a financial loss incurred due to fraudulent or dishonest acts committed by an officer, director, trustee, employee or management agent. Even if not required, it is

prudent for an association to bond those who have access to association funds. Some association's documents require that the bond be in an amount equal to one and one-half year's operating expenses, including reserves. If the bond value is not stipulated in the association documents, a fidelity bond value equal to the amount of three-months' assessments plus the total reserve funds on hand is generally adequate.³⁰ At the very least, the fidelity bond value should equal the maximum amount of funds, including reserves, on hand at any given time.

It is important to note that fidelity bond coverage is very specific and limited; much more so than Comprehensive General Liability coverage. An association is adequately protected against theft or embezzlement of funds only if the fidelity policy is correctly written to specifically include every person having access to association funds. There is no standard language that covers all situations; therefore, an association must ensure that all positions in the organization having access to association funds are specifically named or otherwise identified. Recently, several nationwide management companies have "closed shop" due to financial difficulty. Some associations which had contracted with these companies have now found their own reserve funds to be seriously depleted or missing altogether. Because management company officers who had access to the association accounts were not specifically named in the fidelity bonds, the insurance coverage will not reimburse the associations. Additional sources of information about association insurance include:

- Community Association Insurance, GAP Report #4, 4th Edition, 1997; from Community Associations Institute, 1630 Duke Street, Alexandria, Virginia 22314, (703) 548-8600, or at <http://www.caionline.org>

Worker's Compensation - The Virginia Worker's Compensation Act requires corporations (common interest community associations), firms, or persons that regularly employ three or more full or part-time employees to furnish worker's compensation insurance coverage at no cost to the employee. Worker's compensation pays medical benefits, death benefits, and weekly income to any employee who is injured while working. Employers of fewer than three regular employees, by mutual consent of their employees, can elect to be bound by the Virginia Worker's Compensation Act which is administered by the Virginia Workers' Compensation Commission, online at <http://www.vwc.state.va.us>, or at:

Statewide
P. O. Box 1794
Richmond, VA 23214
(804) 367-8600.
1-877-664-2566 (toll free)

Northern Virginia
P. O. Box 20246
Alexandria, VA 22320
(703) 518-8055

³⁰ Community Association Insurance, CAI-GAP Report #4, pub. by Community Associations Institute, Alexandria, VA, 4th Ed., 1997, pg. 17.

Legal Assistance:

An association consults a professional advisor for an overall picture of its financial condition and risks, but seldom engages in such introspection concerning its legal affairs. In today's litigious environment, what is right or wrong is not always evident, yet ignorance of the law is no excuse for errors and transgressions. Condominium and homeowners associations must act in accordance with the provisions of their governing documents and the laws under which they are established. Consequently, an association may want to retain an attorney to provide routine legal review of its operating procedures to assure that the association's actions are proper and to prevent future legal difficulties. This preventive approach enables an association to identify potential legal problems and situations early, and thereby minimizing legal risks while maximizing legal rights. The following are usually included in a legal status review:

- Interpretation of the association's governing documents to determine its responsibilities and powers;
- review of the association's rule enactment, assessment collection and architectural review procedures to make sure they are consistent with the governing documents, and will stand up in court if challenged;
- review of contracts to make certain the association's interests are adequately protected;
- review of insurance policies to make sure they are consistent with the requirements of the documents and provide adequate legal protection;
- preparation of a model lease or lease clause for use by owners renting their homes to protect the interests of the association by assuring that tenants are aware of their obligation to abide by the association rules and regulations;
- handling of developer-related problems concerning the common areas, or during the period of transition to owner control; and
- providing advice on unfamiliar issues that may have legal implications for the association prior to any action by the board of directors.

A legal audit should also include review of an association's enforcement procedures as applied to covenant and rules violations, and to ensure that due process requirements are met whenever an association takes action against a member. Failure to adequately provide due process requirements may not only be cause for losing an otherwise valid claim, but could be grounds for a liability claim against the directors and the association. An attorney who advises community associations should have specialized knowledge of real property law, contract law, corporation law and condo/homeowner association law. Attorneys who specialize in association law are available at the Fairfax County Bar Association's Lawyer Referral Service at (703) 246-3780 or <http://www.fairfaxbar.org>, the Washington Metropolitan Chapter of Community

Associations Institute at (703) 750-3644 or <http://www.caidec.org>, or property management firms. Other associations can recommend an attorney or law firm who specializes in association law.

Prospective attorneys or firms should be contacted to learn their legal background, qualifications and experience with other associations. When evaluating attorneys, an association should learn:

- the attorney's attitude toward different types of associations and whether he/she usually deals with developers, lenders, and professionally managed associations;
- the attorney's fee structure, what services are provided under the basic fee, what services are extra, and the charges for each;
- other associations with which the attorney is currently working to determine their satisfaction with the attorney's or firm's services;
- if the attorney has the expertise to deal with specific problems and concerns of the association;
- which staff member of a firm will be dealing with the association and what his/her qualifications are; and
- which association documents the attorney needs in addition to the declaration, covenants, bylaws, board members, copies of resolutions and policies, meeting minutes, etc.

Different fee structures are commonly used for association legal work in this area. While the fee will depend on the type of legal work, the amount of time required, the size, age, responsibilities and type of management used by the association, an attorney may charge an annual retainer fee (often billed on a monthly basis). Such retainer may include an initial review of the association's documents and rules and regulations, the establishment of a delinquent assessment collection procedure, telephone consultations, etc., and partial coverage of the costs of such services as contract review or the filing of a personal money judgment. Another attorney who charges an annual retainer fee will charge work done for the association against the retainer and bill the association for services rendered above this amount as they are incurred. An attorney may charge an hourly rate multiplied by the amount of time required for a particular service. Still other attorneys perform an association's legal work for a flat fee or on a fee-for-service rendered basis once a relationship has been established. While some association members may question the expense of required legal counsel, generally when the fee is reviewed on a cost-per-unit-per-month basis, the legal services are seen as a reasonable expense that will help avoid situations that would otherwise involve expensive litigation or other legal difficulties.

Audit Services

A financial audit is a thorough examination of an organization's books, records and accounts to verify their accuracy and that they portray the organization's true financial status. While both the Condominium Act and the Property Owners Association Act are silent regarding

a financial audit, the Virginia Nonstock Corporation Act does require an annual financial audit of any association that is incorporated thereunder. Whether lawfully required or not, an annual audit of an association's records is reasonable and prudent. An audit serves to protect the treasurer and/or management firm, and to assure the board of directors and members that their assessments have been handled properly and that the association is financially stable. An annual audit ensures that an association has the financial status records required by law for prospective buyers. It will include a review of the association's fiscal controls, the procedures used to handle cash receipts and disbursements, the status of the association's reserves and the worthiness of its investment policies, and a determination as to whether the association is meeting the requirements of its governing documents. An auditor may also recommend changes or improvements to the bookkeeping system and provide advice on taxes, investments, reserve funding, etc.

It is important that an auditor hired by a community association be a Certified Public Accountant who is experienced in auditing community associations, and who is knowledgeable about the financial organization and tax status of community associations. Other associations, management firms, and members of organizations such as the Community Associations Institute can provide the names of CPAs who regularly work with associations. Prior to contracting for auditor services, the association should determine the range of services it needs; understand the fee schedules; and know what the audit will entail, the time period that it will cover, and when the audit report will be completed and submitted. The association should be prepared to provide the auditor with copies of the governing documents, the current operating budget, and financial data about the association.

**U.S. Income Tax Return
for Homeowners Associations****2001**

For calendar year 2001 or tax year beginning , 2001, and ending , 20

Use IRS label. Other- wise, please print or type.	Name	Employer identification number (see page 4)
	Number, street, and room or suite no. (If a P.O. box, see page 4.)	Date association formed
	City or town, state, and ZIP code	

Check if: (1) ☐ Final return (2) ☐ Name change (3) ☐ Address change (4) ☐ Amended return**A** Check type of homeowners association: ☐ Condominium management association ☐ Residential real estate association ☐ Timeshare association**B** Total exempt function income. Must meet 60% gross income test (see instructions) **B****C** Total expenditures made for purposes described in 90% expenditure test (see instructions) **C****D** Association's total expenditures for the tax year (see instructions) **D****E** Tax-exempt interest received or accrued during the tax year **E****Gross Income** (excluding exempt function income)

1	Dividends	1		
2	Taxable interest	2		
3	Gross rents	3		
4	Gross royalties	4		
5	Capital gain net income (attach Schedule D (Form 1120))	5		
6	Net gain or (loss) from Form 4797, Part II, line 18 (attach Form 4797)	6		
7	Other income (excluding exempt function income) (attach schedule)	7		
8	Gross income (excluding exempt function income). Add lines 1 through 7	8		

Deductions (directly connected to the production of gross income, excluding exempt function income)

9	Salaries and wages	9		
10	Repairs and maintenance	10		
11	Rents	11		
12	Taxes and licenses	12		
13	Interest	13		
14	Depreciation (attach Form 4562)	14		
15	Other deductions (attach schedule)	15		
16	Total deductions. Add lines 9 through 15	16		
17	Taxable income before specific deduction of \$100. Subtract line 16 from line 8	17		
18	Specific deduction of \$100	18	\$100	00

Tax and Payments

19	Taxable income. Subtract line 18 from line 17	19		
20	Enter 30% of line 19. (Timeshare associations, enter 32% of line 19.)	20		
21	Tax credits (see instructions)	21		
22	Total tax. Subtract line 21 from line 20. See instructions for recapture of certain credits	22		
23	Payments: a 2000 overpayment credited to 2001 23a			
	b 2001 estimated tax payments 23b	c Total ▶ 23c		
	d Tax deposited with Form 7004 23d			
	e Credit for tax paid on undistributed capital gains (attach Form 2439) 23e			
	f Credit for Federal tax on fuels (attach Form 4136) 23f			
	g Add lines 23c through 23f 23g			
24	Tax due. Subtract line 23g from line 22. See instructions for depository method of tax payment	24		
25	Overpayment. Subtract line 22 from line 23g	25		
26	Enter amount of line 25 you want: Credited to 2002 estimated tax ▶ Refunded ▶	26		

**Sign
Here**

Under penalties of perjury, I declare that I have examined this return, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Signature of officer

Date

Title

May the IRS discuss this return
with the preparer shown below
(see instructions)? ☐ Yes ☐ No**Paid
Preparer's
Use Only**Preparer's
signature

Date

Check if
self-employed ☐

Preparer's SSN or PTIN

Firm's name (or
yours if self-employed),
address, and ZIP code

EIN

Phone no. ()

Changes To Note

- The association may need to mail its return to a different service center this year because the IRS has changed the filing location for several areas. See **Where To File** on page 3.
- If the corporation wants to allow the IRS to discuss its 2001 tax return with the paid preparer who signed it, check the "Yes" box in the area where the officer of the corporation signed the return. See page 3 for details.

How To Get Forms and Publications

Personal computer. You can access the IRS Web Site 24 hours a day, 7 days a week at **www.irs.gov** to:

- Download forms, instructions, and publications.
- See answers to frequently asked tax questions.
- Search publications on-line by topic or keyword.
- Send us comments or request help by e-mail.
- Sign up to receive local and national tax news by e-mail.

You can also reach us using file transfer protocol at **ftp.irs.gov**.

CD-ROM. Order **Pub. 1796**, Federal Tax Products on CD-ROM, and get:

- Current year forms, instructions, and publications.
- Prior year forms, instructions, and publications.
- Frequently requested tax forms that may be filled in electronically, printed out for submission, and saved for recordkeeping.
- The Internal Revenue Bulletin.

Buy the CD-ROM on the Internet at **www.irs.gov/cdorders** from the National Technical Information Service (NTIS) for \$21 (no handling fee), or call **1-877-CDFORMS** (1-877-233-6767) toll free to buy the CD-ROM for \$21 (plus a \$5 handling fee).

By phone and in person. You can order forms and publications 24 hours a day, 7 days a week, by calling **1-800-TAX-FORM** (1-800-829-3676). You can also get most forms and publications at your local IRS office.

General Instructions

Section references are to the Internal Revenue Code unless otherwise noted.

Purpose of Form

A homeowners association files Form 1120-H as its income tax return to take advantage of certain tax benefits. These benefits, in effect, allow the association to exclude exempt function income (defined below) from its gross income.

Electing To File Form 1120-H

A homeowners association elects to take advantage of the tax benefits provided by section 528 by filing a properly completed Form 1120-H. The election is made separately for each tax year and generally must be made by the due date, including extensions, of the income tax return.

See Regulations section 301.9100-2 for information on a 12-month extension of time to make the election. This extension does not extend the time to pay the tax. Once Form 1120-H is filed, the association cannot revoke its election for that year unless the IRS consents. The association may request IRS consent by filing a ruling request. A user fee must be paid with all ruling requests. For more information on ruling requests, see Rev. Proc. 2001-1, 2001-1 I.R.B. 1.

If the association does not elect to use Form 1120-H, it must file the applicable income tax return (Form 1120, etc.).

A homeowners association should compare its total tax computed on Form 1120-H with its total tax computed on either **Form 1120**, U.S. Corporation Income Tax Return, or **Form 1120-A**, U.S. Corporation Short-Form Income Tax Return. The association may file the form that results in the lowest tax.

Note: *The taxable income of a homeowners association that files its tax return on Form 1120-H is taxed at a flat rate of 30% for condominium management associations and residential real estate associations. The tax rate for timeshare associations is 32%. These rates apply to both ordinary income and capital gains.*

If the association is tax exempt under section 501(a), **do not** file Form 1120-H. See section 6033 and related regulations. If the association loses its exempt status, see Regulations section 1.528-8(e).

Definitions

Homeowners association. There are three kinds of homeowners associations:

1. A **condominium management association** organized and operated to acquire, build, manage, maintain, and care for the property in a condominium project substantially all of whose units are homes for individuals.

2. A **residential real estate management association** organized and operated to acquire, build, manage, maintain, and care for a subdivision, development, or similar area substantially all of whose lots or buildings are homes for individuals.

3. A **timeshare association** (other than a condominium management association), organized and operated to acquire, build, manage, maintain, and care for the property that has members who hold a timeshare right to use, or a timeshare ownership interest in, real property of the timeshare association. A timeshare association cannot be a condominium management association.

See Regulations section 1.528-4 for information regarding the "substantially all" test for condominium management associations and residential real estate management associations.

To qualify as a homeowners association, the following must apply.

- At least 60% of the association's gross income for the tax year must consist of exempt function income (see below).
- At least 90% of the association's expenses for the tax year must consist of expenses to acquire, build, manage, maintain, or care for its property, and, in the case of a timeshare association, for activities provided to, or on behalf of, members of the timeshare association.
- No private shareholder or individual can profit from the association's net earnings except by acquiring, building, managing, or caring for association property or by a rebate of excess membership dues, fees, or assessments.
- The association must file Form 1120-H to elect under section 528 to be treated as a homeowners association.

Association property. Association property includes real and personal property that:

1. The association holds,
2. The association's members hold in common,
3. The association's members hold privately within the association, and
4. Is owned by a governmental unit and is used to benefit the unit's residents.

The timeshare association or its members have rights arising out of recorded easements, covenants, or other recorded instruments to use property related to the timeshare project.

For more information, see Regulations section 1.528-3.

Taxable income. Taxable income is the excess, if any, of:

1. Gross income for the tax year, excluding exempt function income, over
2. Allowed deductions directly connected with producing any gross income except exempt function income. Allowed deductions include a specific \$100 deduction. The following are not allowed:
 - Net operating loss deduction (section 172).
 - Deductions under Part VIII of subchapter B (special deductions for corporations).

If facilities are used (or personnel are employed) for both exempt and nonexempt purposes, see Regulations section 1.528-10.

Exempt function income. Exempt function income consists of membership dues, fees, or assessments from (a) owners of condominium housing units, (b) owners of real property in the case of a residential real estate management association, or (c) owners of timeshare rights to use, or timeshare ownership interests in, real property in the case of a timeshare association. This income must come from the members as owners, not as customers, of the association's services.

Assessments or fees for a common activity qualify but charges for providing services do not qualify.

Examples. In general, exempt function income includes assessments made to:

1. Pay principal, interest, and real estate taxes on association property.
2. Maintain association property.
3. Clear snow from public areas and remove trash.

Income that is **not** exempt function income includes:

1. Amounts that are not includible in the organization's gross income other than under section 528 (for example, tax-exempt interest).
2. Payments from nonmembers.
3. Payments from members for special use of the organization's facilities, apart from the use generally available to all members.
4. Interest on amounts in a sinking fund.
5. Payments for work done on nonassociation property.
6. Members' payments for transportation.

For more information, see Regulations section 1.528-9.

When To File

Generally, an association must file Form 1120-H by the 15th day of the 3rd month after the end of the tax year.

If the due date falls on a Saturday, Sunday, or legal holiday, the association may file on the next business day.

Private delivery services. You can use certain private delivery services designated by the IRS to meet the "timely mailing as timely filing/paying" rule for tax returns and payments. See the instructions for Form 1120 for details.

Extension. File **Form 7004**, Application for Automatic Extension of Time To File Corporation Income Tax Return, to request a 6-month extension of time to file.

Who Must Sign

The return must be signed and dated by the president, vice-president, treasurer, assistant treasurer, chief accounting officer, or any other association officer (such as a tax officer) authorized to sign. Receivers, trustees, or assignees must sign and date any return filed on behalf of an association.

If an association officer completes Form 1120-H, the paid preparer's space should remain blank. Anyone who prepares Form 1120-H but does not charge the association should not sign the return. Generally, anyone who is paid to prepare the return must sign it and fill in the "Paid Preparer's Use Only" area.

The **paid preparer** must complete the required preparer information and—

- Sign the return, by hand, in the space provided for the preparer's signature (signature stamps and labels are not acceptable).
- Give a copy of the return to the taxpayer.

Where To File

File the association's return at the applicable IRS address listed below.

If the association's principal business or office is located in:	Use the following Internal Revenue Service Center address:
Connecticut, Delaware, District of Columbia, Illinois, Indiana, Kentucky, Maine, Maryland, Massachusetts, Michigan, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, Vermont, Virginia, West Virginia, Wisconsin	Cincinnati, OH 45999-0012
Alabama, Alaska, Arizona, Arkansas, California, Colorado, Florida, Georgia, Hawaii, Idaho, Iowa, Kansas, Louisiana, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Tennessee, Texas, Utah, Washington, Wyoming	Ogden, UT 84201-0012
Outside the United States	Philadelphia, PA 19255-0012

Paid Preparer Authorization

If the association wants to allow the IRS to discuss its 2001 tax return with the paid preparer who signed it, check the "Yes" box in the signature area of the return. This authorization applies only to the individual whose signature appears in the "Paid Preparer's Use Only" section of the association's return. It does not apply to the firm, if any, shown in that section.

If the "Yes" box is checked, the association is authorizing the IRS to call the paid preparer to answer any questions that may arise during the processing of its return. The association is also authorizing the paid preparer to:

- Give the IRS any information that is missing from the return,
- Call the IRS for information about the processing of the return or the status of any related refund or payment(s), and
- Respond to certain IRS notices that the association has shared with the preparer about math errors, offsets, and return preparation. The notices will not be sent to the preparer.

The association is not authorizing the paid preparer to receive any refund check, bind the association to anything (including any additional tax liability), or otherwise represent the association before the IRS. If the association wants to expand the paid preparer's authorization, see **Pub. 947**, Practice Before the IRS and Power of Attorney.

The authorization cannot be revoked.

However, the authorization will automatically end no later than the due date (without extensions) for filing the association's 2002 tax return.

Other Forms and Statements That May Be Required

The association may have to file some of the following. See the form for more information.

Form W-2, Wage and Tax Statement and **Form W-3**, Transmittal of Wage and Tax Statements. Use these forms to report wages, tips, and other compensation, withheld income, social security, and Medicare taxes for employees.

Form 940 or **Form 940-EZ**, Employer's Annual Federal Unemployment (FUTA) Tax Return. The association may be liable for FUTA tax and may have to file Form 940 or Form 940-EZ if either of the following applies.

- It paid wages of \$1,500 or more in any calendar quarter in 2000 or 2001, or
- It had at least one employee who worked for the association for some part of a day in 20 or more different weeks in 2000 or 20 or more different weeks in 2001.

Form 941, Employer's Quarterly Federal Tax Return. File this form quarterly to report income tax withheld and employer and employee social security/Medicare taxes.

Form 945, Annual Return of Withheld Federal Income Tax. File this form to report income tax withheld from nonpayroll distributions or payments.

Form 1098, Mortgage Interest Statement. Use this form to report the receipt of \$600 or more of mortgage interest (including points) in the course of the association's trade or business.

Forms 1099-A, B, DIV, INT, MISC, and S. Use these information returns to report acquisitions and abandonments of secured property, proceeds from broker and barter exchange transactions, certain dividends and distributions, interest income, miscellaneous income (e.g., payments to providers of health and medical services; miscellaneous income payments and nonemployee compensation), and proceeds from real estate transactions. Also use these returns to report amounts that were received as a nominee on behalf of another person.

For more information, see the Instructions for Forms 1099, 1098, 5498, and W-2G.

Form 8300, Report of Cash Payments Over \$10,000 Received in a Trade or Business. Use this form to report the receipt of more than \$10,000 in cash or foreign currency in one transaction or in a series of related transactions.

Assembling the Return

Attach **Form 4136**, Credit for Federal Tax Paid on Fuels, to Form 1120-H. Attach schedules in alphabetical order and additional forms in numerical order after Form 4136.

Complete every applicable entry space on Form 1120-H. Do not write "See Attached" instead of completing the entry spaces. If more space is needed on the forms or schedules, attach separate sheets using the same size and format as the printed forms. If there are supporting statements and attachments, arrange them in the same order as the schedules or forms they support and attach them last. Show the totals on the printed forms. Also, be sure to enter the association's name and EIN on each supporting statement or attachment.

Accounting Methods

Figure taxable income using the method of accounting regularly used in keeping the association's books and records. Generally, permissible methods include cash, accrual, or any other method authorized by the Internal Revenue Code. In all cases, the method used must clearly reflect taxable income.

Generally, an accrual basis taxpayer can deduct accrued expenses in the tax year in which (a) all events that determine the liability have occurred, (b) the amount of the liability can be figured with reasonable accuracy, and (c) economic performance takes place with respect to the expense. There are exceptions for recurring items. See section 461(h) and the related regulations for the rules for determining when economic performance takes place.

Generally, the association must get IRS consent to change the method of accounting used to report taxable income (for income as a whole or any material item). To do so, it must file **Form 3115**, Application for Change in Accounting Method. For more information, get **Pub. 538**, Accounting Periods and Methods.

Change of Tax Year

Generally, an association must get the consent of the IRS before changing its tax year by filing **Form 1128**, Application To Adopt, Change, or Retain a Tax Year. However, under certain conditions, an association may change its tax year without getting the consent. See Regulations section 1.442-1 and Pub. 538.

Rounding Off to Whole Dollars

The association may show amounts on the return and accompanying schedules as whole dollars. To do so, drop amounts less than 50 cents and increase amounts from 50 cents through 99 cents to the next higher dollar.

Depository Method of Tax Payment

The association must pay the tax due in full no later than the 15th day of the 3rd month after the end of the tax year. The two methods of depositing association income taxes are discussed below.

Electronic Deposit Requirement

The association must make electronic deposits of all depository taxes (such as employment tax, excise tax, and corporate income tax) using the Electronic Federal Tax Payment System (EFTPS) in 2002 if:

- The total deposits of such taxes in 2000 were more than \$200,000 or
- The association was required to use EFTPS in 2001.

If the association is required to use EFTPS and fails to do so, it may be subject to a 10% penalty. If the association is not required to use EFTPS, it may participate voluntarily. To enroll in or get more information about EFTPS, call 1-800-555-4477 or 1-800-945-8400 or visit the EFTPS website at www.eftps.gov.

Depositing on time. For EFTPS deposits to be made timely, the association must initiate the transaction at least 1 business day before the date the deposit is due.

Deposits With Form 8109. If the association does not use EFTPS, deposit association income tax payments (and estimated tax payments) with **Form 8109**, Federal Tax Deposit Coupon. If you do not have a preprinted Form 8109, use Form 8109-B to make deposits. You can get this form by calling 1-800-829-1040. Be sure to have your EIN ready when you call.

Do not send deposits directly to an IRS office; otherwise, the association may have to pay a penalty. Mail or deliver the completed Form 8109 with the payment to an authorized depository, i.e., a commercial bank or other financial institution authorized to accept Federal tax deposits. Make checks or money orders payable to the depository.

To help ensure proper crediting, write the association's EIN, the tax period to which the deposit applies, and "Form 1120-H" on the check or money order. Be sure to darken the "1120" box on the coupon. Records of these deposits will be sent to the IRS.

If you prefer, you may mail your coupon and payment to Financial Agent, Federal Tax Deposit Processing, P.O. Box 970030, St. Louis, MO 63197. Make check or money order payable to "Financial Agent."

For more information on deposits, see the instructions in the coupon booklet (Form 8109) and **Pub. 583**, Starting a Business and Keeping Records.

Caution: If the association owes tax when it files Form 1120-H, do not include the payment with the tax return. Instead, mail or deliver the payment with Form 8109 to an authorized depository, or use EFTPS, if applicable.

Estimated Tax, Alternative Minimum Tax, and Certain Tax Credits

These items do not apply to homeowners associations electing to file Form 1120-H. See the instructions for line 21 below for a list of the tax credits that do not apply. However, a homeowners association that does **not** elect to file Form 1120-H may be required to make payments of estimated tax. Because the election is **not** made until the return is filed, Form 1120-H provides lines for estimated tax payments and the crediting of overpayments against estimated tax if payments or overpayments apply.

Interest and Penalties

Interest. Interest is charged on taxes paid late even if an extension of time to file is granted. Interest is also charged on penalties imposed for failure to file, negligence, fraud, gross valuation overstatements, and substantial understatement of tax from the due date (including extensions) to the date of payment. The interest charge is figured at a rate determined under section 6621.

Penalty for late filing of return. In addition to losing the right to elect to file Form 1120-H, a homeowners association that does not file its tax return by the due date, including extensions, may be penalized 5% of the unpaid tax for each month or part of a month the return is late, up to a maximum of 25% of the unpaid tax. The minimum penalty for a return that is over 60 days late is the smaller of the tax due or \$100. The penalty will not be imposed if the association can show that the failure to file on time was due to reasonable cause. Associations that file late must attach a statement explaining the reasonable cause.

Penalty for late payment of tax. An association that does not pay the tax when due generally may be penalized 1/2 of 1% of the unpaid tax for each month or part of a month the tax is not paid, up to a maximum of 25% of the unpaid tax. The penalty will not be imposed if the association can show that the failure to pay on time was due to reasonable cause.

Other penalties. Other penalties can be imposed for negligence, substantial understatement of tax, and fraud. See sections 6662 and 6663.

Specific Instructions

Period covered. File the 2001 return for calendar year 2001 and fiscal years that begin in 2001 and end in 2002. For a fiscal year return, fill in the tax year space at the top of the form.

Note: The 2001 Form 1120-H may also be used if (a) the association has a tax year of less than 12 months that begins and ends in 2002 and (b) the 2002 Form 1120-H is not available at the time the association is required to file its return.

However, the association must show its 2002 tax year on the 2001 Form 1120-H and must incorporate any tax law changes that are effective for tax years beginning after 2001.

Address. Include the suite, room, or other unit number after the street address. If a pre-addressed label is used, include this information on the label.

If the Post Office does not deliver mail to the street address and the association has a P.O. box, show the box number instead of the street address.

Note: If a change in address occurs after the return is filed, the association can use **Form 8822**, Change of Address, to notify the IRS of the new address.

Employer identification number (EIN). Show the correct EIN in the space provided. If the association does not have an EIN, it should apply for one on **Form SS-4**, Application for Employer Identification Number. If the association has not received its EIN by the time the return is due, write "Applied for" in the space for the EIN. See Pub. 583 for details.

Final return, name change, address change, or amended return.

- If the association ceases to exist, file Form 1120-H and check the "Final return" box.
- If the association has changed its address since it last filed a return, check the box for "Address change."
- If the association changed its name since it last filed a return, check the box for "Name change."
- To amend a previously filed Form 1120-H, file a corrected Form 1120-H and check the "Amended return" box.

Item B—60% exempt function income test. At least 60% of the association's gross income for the tax year must consist of exempt function income (see **Definitions** on page 2).

Item C—90% expenditure test. At least 90% of the association's expenditures for the tax year must consist of expenses to acquire, build, manage, maintain, and care for property, and in the case of a timeshare association, for activities provided to, or on behalf of, members of the timeshare association. Include current and capital expenditures. Use the association's accounting method to figure the total.

Include:

1. Salary for an association manager or secretary.
2. Expenses for gardening, paving, street signs, security guards, and property taxes assessed on association property.
3. Current operating and capital expenditures for tennis courts, swimming pools, recreation halls, etc.
4. Replacement costs for common buildings, heating, air conditioning, elevators, etc.

Do not include expenditures for property that is not association property. Also, do not include investments or transfers of funds held to meet future costs. An example would be transfers to a sinking fund to replace a roof, even if the roof is association property.

Item D. Enter the association's total expenditures for the tax year including those expenditures directly related to exempt function income. Use the association's accounting method to figure the entry for item D.

Item E. Show any tax-exempt interest received or accrued. Include any exempt-interest dividend received as a shareholder in a mutual fund or other regulated investment company.

Line 21—Tax credits. The association may qualify for the following tax credits:

Foreign tax credit. See **Form 1118**, Foreign Tax Credit—Corporations.

Credit for fuel produced from a nonconventional source. See section 29 for a definition of qualified fuels, provisions for figuring the credit, and other special rules.

Qualified electric vehicle credit. See **Form 8834**, Qualified Electric Vehicle Credit, and section 30.

The general business credit (but not the investment credit, the Indian employment credit, the work opportunity credit, the welfare-to-work credit, or the empowerment zone employment credit). See **Form 3800**, General Business Credit.

Note: The association may not claim the qualified zone academy bond credit.

Enter the total amount of credits on line 21 and attach the appropriate form(s).

Line 22. If the association must recapture any of the low-income housing credit (or the qualified electric vehicle credit), include the amount of the recapture in the total for line 22. To the right of the entry space, write "LIH recapture" (or "QEV recapture") and the amount. See **Form 8611**, Recapture of Low-Income Housing Credit, and section 42(j) for more details. See Regulations section 1.30-1 for details on how to figure the recapture for the qualified electric vehicle credit.

Backup withholding. If the association had income tax withheld from any payments it received, because, for example, it failed to give the payer its correct EIN, include this amount in the total for line 23g. This type of withholding is called "Backup Withholding." Show the amount withheld in the blank space in the right-hand column between lines 22 and 23g, and write "Backup Withholding."

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is:

Recordkeeping 11 hr., 43 min.

Learning about the law or the form 5 hr., 19 min.

Preparing the form 13 hr., 12 min.

Copying, assembling, and sending the form to the IRS 2 hr., 9 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. You can write to the Tax Forms Committee, Western Area Distribution Center, Rancho Cordova, CA 95743-0001. **Do not** send the tax form to this office. Instead, see **Where To File** on page 3.

